



Highlights & Analysis of the Governor's Budget

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OVERVIEW

After three consecutive years of major expansion in the size of state government, the Governor's Budget for 2002-03, proposes deferrals, borrowing, re-financing, and some reductions in cost growth to address a shortfall that the Legislative Analyst's Office (LAO) estimated in November to be \$12.4 billion. The shortfall is due to a dramatic, but not unexpected downturn in revenues combined with a three-year increase of 36 percent in General Fund spending.

Spending Growth Slowed, but Long-term Shortfalls Remain

The Budget reduces the rate of growth in state spending, taking credit for \$5.3 billion in "spending reductions." It is important to note, however, that the overall level of spending proposed for 2002-03 is still 36.3 percent higher than spending in the final year of the prior administration, but only marginally above 2001-02 levels. Contrary to claims that education is this Administration's highest priority, the largest increase is for Health and Human Services, which is proposed at \$22.4 billion, which is \$6.4 billion, or 40 percent, higher than in the last year of the previous administration. This compares to a 33-percent 4-year increase for K-12 education.

In November, the LAO stated that failure to address the long-term structural imbalances in the state's budget would result in chronic shortfalls in future years. The Budget appears to contribute little toward a solution to this problem. While the reduction in spending growth may reduce the out-year shortfalls by as much as half of the \$4 billion projected by the LAO, other elements of the Budget actually aggravate the problem by moving costs into the out-years.

Optimistic Revenue Estimates

The Budget projects General Fund revenues in 2001-02 and 2002-03 that total \$2.3 billion more than forecast by the LAO in November. In light of trends in current receipts, this would appear to be an optimistic forecast. The Budget also includes over \$1 billion in General Fund offsets due to optimistic assumptions of increases in various federal funds. It also assumes the repayment of a \$6 billion loan from the General Fund to purchase electricity last year. Finally, the Budget proposes an extremely low reserve of \$500 million. These uncertainties make the cash-flow projections in the Budget highly suspect. Therefore there is a strong possibility that the state will need to borrow money to make it through the current year.

Borrowing from the Future to Cover the Excesses of the Past

Perhaps the most distinguishing feature of this Budget is the extent to which it relies on borrowing. The Budget document actually overtly acknowledges a total of \$5.6 billion in borrowing. Taken at face value, this indicates that 45 percent of the Budget “solutions” depend on borrowing from the future. As we discuss in more detail below, however, there are significant uncertainties regarding the impact of the Budget on future years’ costs, which could significantly increase the actual amount of “borrowing” in this Budget.

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ECONOMIC FORECAST

National Outlook

Most economists believe that the current recession began in March of 2001. Business spending has been soft for almost two years, but consumer spending kept the economy from shrinking up until that time. The terrorist attacks of September 11 pushed the U.S. economy deeper into recession when consumer and business spending buckled in the weeks immediately following the attacks. There are positive signs that consumer spending has subsequently experienced a partial rebound, but most indicators of business confidence and spending remain weak. Post September 11, orders for manufactured goods dropped, and firms throughout the economy announced layoffs. Particularly hard hit were companies in the travel, airline, and aircraft manufacturing sectors. Between September and October, the U.S. economy lost over 400,000 jobs and the unemployment rate jumped from 4.9 percent to 5.4 percent. Responding to the weakness in the economy, the Federal Reserve moved aggressively to lower interest rates, and the President and Congress considered tax and spending measures designed to stimulate future economic growth. No national economic stimulus package has been approved yet.

The budget forecast assumes that the U.S. economy will remain in recession through early 2002, but that a rebound will begin in the second quarter of 2002. The key assumptions behind this forecast are that (1) businesses will increase spending in 2002, (2) federal monetary and fiscal policies will have an economic stimulus effect and (3) the effects of the September 11 attacks on consumer and business activity will gradually subside. The budget forecast assumes that growth in GDP will accelerate from 0.5 percent in 2002 to 4.4 percent in 2003. The unemployment rate, which stood at 4.8 percent in 2001, is projected to peak at about 6.2 percent in mid-2002 before dropping back to 5.7 percent by the end of 2003.

California's Outlook

Prior to the Spring of 2001, California had experienced almost eight years of economic expansion. However, California entered a recession in 2001 along with the rest of the nation. The budget forecast assumes that the economic downturn in California will rebound in the second quarter of 2002, consistent with the projections of national economic performance. Factors contributing to the economic downturn include ongoing weakness in high-tech spending, the negative impact of recent stock market declines on wealth, income, and consumer and business spending in the state, and the adverse effects of the September 11 attacks on the state's travel and tourism-related industries. The downturn in state employment is forecast to be relatively modest by historical standards. However, income declines will be substantial due to the reductions in jobs and stock options in the high-paying IT-related sectors of the economy. The economic slowdown is also impacting a wide variety of other California industry sectors including construction, real estate, manufacturing, and retail sales.

STATE GENERAL FUND REVENUE FORECAST

Signs of the recession's impact on state revenues were in evidence as early as last January, when economists at UCLA and the LAO warned of a weakening in revenue growth and the potential for a slowing down of the economy. By the time the Budget Act was signed in July, even the DOF had reduced its revenue forecasts substantially. In August, the LAO warned of further declines, and by the time the LAO published its November forecast, revenue projections for 2000-01 and 2001-02 combined had declined by an estimated \$6.8 billion.

An important indicator of the revenue slowdown is the reduction in personal income tax (PIT) withholding. Year-over-year growth in PIT was running above 20 percent during the peak of California's economic expansion in early 2000, but had slid to a *minus* 6 percent as of the third quarter of this year. Sales tax receipts and quarterly income tax prepayments from individuals and corporations are also way down as compared to 2000.

The General Fund revenue forecast includes various one-time "revenue accelerations," receipt of special fund loans and balance transfers to increase total resources available. These total approximately \$366 million in the current year and \$3.85 billion in the budget year for a total of \$4.2 billion. After making accounting adjustments for how the energy bond proceeds are reflected and also adjusting for the proposed new one-time revenue transfers and accelerations into the General Fund, total revenues are projected to decline from \$77.6 billion in 2000-01 to \$70.1 billion in 2001-02. This is a drop of 9.6 percent reflecting the softening economy and a sharp drop in capital gains and stock options-related revenue. The Budget projects that revenues will rebound partially in 2002-03, with receipts increasing to \$75.5 billion. This is \$2.1 billion less than the General Fund receipts in 2000-01. *It is important to note that the Administration's current-year revenue estimate is \$1.8 billion **higher** than the LAO's November forecast. Recent data from December 2001 and January 2002 estimated payments are more consistent with the LAO forecast. Accordingly, the Governor's Budget may be overestimating revenues by close to \$2 billion. If this turns out to be true, the budget deficit would grow to \$14.5 billion requiring further adjustments in the May Revision.*

In the November 2001 "Fiscal Outlook", the LAO stated that a delay in the economic recovery would significantly hurt the budget's revenue forecast. *The LAO estimated that a six-month delay in the recovery—from spring 2002 to fall 2002—would reduce budget-year revenues by \$3 billion to \$4 billion below their November forecast.*

The General Fund revenue estimate includes the following main components:

- **Personal Income Tax (PIT):** After increasing from \$16.3 billion in 1994-95 to \$44.6 billion in 2000-01, the budget forecasts that PIT revenues will decline to \$38.5 billion in 2001-02—a drop of 13.8 percent. This current-year decline is the steepest in the past three decades. The budget forecasts that PIT revenues will partially rebound to \$42.6 billion in 2002-03. The single largest factor behind the drop in PIT receipts in the current year is the huge decline in capital gains and stock options. At their peak, these sources accounted for over \$17 billion in PIT revenues in 2000-01, over 22 percent of total General Fund revenues during that year. The sharp drop in this revenue source is directly related to the drop in stock market valuations over the past year, particularly in California's high-tech sector.
- **Sales & Use Tax (SUT):** Both consumer and business spending have been soft since the beginning of 2001. This reflects several factors, including the general economic slowdown, the loss of stock market-related wealth and income, declines in capital investment by business and the adverse effects of higher energy prices on household budgets. Following an increase of 11.5 percent in 1999-00, General Fund revenues from this source remained flat in 2000-01 at \$21.3 billion. SUT is forecasted to decline in 2001-02 to \$21.2 billion. The forecast assumes that revenues will rebound by 7.9 percent in 2002-03, increasing to \$22.9 billion during the year. The forecast includes the additional revenue generated by the ¼ cent sales tax increase effective January 1, 2002 (\$500 million in 2001-02 and \$1.1 billion in 2002-03), and it includes the effect on sales tax receipts from the rural tax relief legislation enacted in 2001 (roughly \$40 million annually).

- **Bank and Corporate Tax (BCT):** The recession is having a significant negative impact on corporate earnings. Reports indicate that corporate profits throughout the U.S. are being impacted by sluggish domestic and international sales, falling product prices, idle capacity, higher health care costs and related economic factors. The reduction in high-tech spending is having a particularly heavy impact on California's economy because California accounts for roughly 20 percent of the nation's IT industry. The budget forecasts that BCT revenues will fall sharply from \$6.9 billion in 2000-01 to \$5.3 billion in 2001-02, before partially rebounding to \$5.9 billion in 2002-03.

STATE GENERAL FUND REVENUES

	Governor's Budget	LAO November Estimate	Difference Between Estimates *
(\$'s in millions)			
Fiscal Year 00-01			
Personal Income Tax	\$44,614	\$44,776	-\$162
Sales & Use Tax	\$21,277	\$21,292	-\$15
Bank & Corporate Tax	\$6,899	\$6,443	\$456
Other Revenues & Transfers	-\$1,362	\$5,173	-\$6,535
Total	\$71,428	\$77,684	-\$6,256
Fiscal Year 01-02			
Personal Income Tax	\$38,455	\$36,660	\$1,795
Sales & Use Tax	\$21,165	\$21,180	-\$15
Bank & Corporate Tax	\$5,261	\$5,220	\$41
Other Revenues & Transfers	\$12,202	\$5,263	\$6,939
Total	\$77,083	\$68,323	\$8,760
Fiscal Year 02-03			
Personal Income Tax	\$42,605	\$41,740	\$865
Sales & Use Tax	\$22,850	\$23,120	-\$270
Bank & Corporate Tax	\$5,869	\$5,900	-\$31
Other Revenues & Transfers	\$7,981	\$3,867	\$4,114
Total	\$79,305	\$74,627	\$4,678

*The Administration's revenue numbers in this chart include accounting adjustments for the energy bond proceeds and also loan proceeds and revenue transfers into the General Fund announced by the Governor on January 10, 2002, and which are not reflected in the LAO revenue estimates from the November forecast. For this reason, they differ, in some cases from the General Fund revenue totals cited above.

Reserve For Economic Uncertainty

The state ended the 2000-01 fiscal year with a General Fund reserve of \$5.98 billion. The Budget Act of 2001 assumed a General Fund reserve of \$2.6 billion as of June 30th, 2002. However, due to the reduction in revenues discussed above, the reserve has been dramatically reduced. The 2002-03 Governor's Budget now assumes an extremely small reserve of only \$12 million for fiscal year 2001-02 ending June 30th, 2002 and a 2002-03 ending reserve of only \$511 million. This is only 6/100th of one percent of estimated General Fund revenues. Furthermore, the ending reserve in 2001-02 is less than 1/100th of one percent of estimated General Fund revenue.

Cashflow Problems Loom

The Budget continues to assume the June 2002 receipt of \$6.5 billion in General Fund revenues that were originally loaned to pay for electricity purchases. The \$6.5 billion will come from the proceeds of a \$14 billion Energy Revenue Bonds, which is currently stalled due to Public Utilities Commission inaction. In addition, the Budget contains increased special fund borrowing in the current year and it is not clear how realistic these estimates are, nor has the DOF yet explained how the additional borrowing will affect the programs that rely on these special funds. Finally, the optimistic revenue assumptions in the Budget put the state at risk of having to make a last minute adjustment in the cash-flow plan. Taken together, these factors suggest that the state may have to issue registered warrants or borrow money using a Revenue Anticipation Warrant (RAW) before the end of the current year.

TAX ISSUES

1/4 Cent Sales Tax Increase

The Governor's Budget includes in its revenue forecast **\$1.1 billion** in sales tax revenue for calendar year 2002 related a ¼ cent sales tax increase that took effect January 1, 2002. The budget assumes that this **\$1.1 billion** tax increase continues in calendar year 2003. In 1991, the State faced budget deficits of over \$14 billion. To address this dramatic shortfall in State revenues, a series of expenditure reductions and revenue increases were enacted as part of the final budget agreement between Governor Wilson and the Democrat controlled Legislature. One of the revenue increases was a ¼ cent sales tax increase which generated revenue for the State General Fund in the amount of about \$700 to \$800 million at that time. This increase included a provision that would require the ¼ cent increase to sunset when the General Fund reserve reached four percent as determined by the Director of Finance. However, a budget trailer bill in 2001 included a provision modifying this sales tax trigger. Under the new law, the ¼ cent sales tax sunsets when the General Fund reserve reaches *three* percent as determined by the Director of Finance. Because the Governor's Budget assumes a reserve of only 6/100th of one percent, the tax increase will remain in place unless the Legislature makes more reductions in spending to increase the reserve.

Retirement and Education Savings Account Conformity

The federal Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) cut income tax rates and gave rebates to most taxpayers. It also increased contribution limits to Education, Roth and Traditional Individual Retirement Accounts, defined benefit plans including PERS, 401(k), 403(b) and 457 plans, and qualified tuition plans. The EGTRRA also allows those who've lagged behind in saving for retirement to accelerate contributions to their pension plans. Current California law does not conform to the federal law and thus prevents Californians from benefiting from the EGTRRA. This could result in State taxpayers losing millions of dollars in retirement and education savings available in most other states, which already have conformed.

The Governor's Budget assumes adoption of most provisions of EGTRRA. Exact details of the Governor's proposal are not yet available. The Franchise Tax Board estimates the budget year cost of full conformity at \$44 million and increasing over time to \$207 million by 2009-10. California is 1 of only 19 non-conforming states. The other 18 states are actively considering full conformity.

Other Conformity Issues Raising Taxes

In addition to EGTRRA conformity, the Governor's Budget proposes offsetting conformity provisions, which will increase taxes. While the details on the Governor's plan are not yet available, it appears the proposal would conform California law to federal regarding estimated payments and provide that any federal election for corporations applies for state tax purposes (i.e. sub chapter S and C designations). These provisions, when combined with the tax decreases associated with the EGTRRA, would result in a net General Fund impact \$178 million in increased tax revenues in 2002-03.

Budget Suggests Sales Tax Hike on Farmers

AB 426 (Cardoza) was a 2001 budget trailer bill, which provided sales tax exemptions for, liquefied petroleum gas, farm and forestry equipment, diesel fuel used in farming activities and for racehorse breeding stock, among other provisions. The Board of Equalization recently adopted regulations that expand the agricultural sales tax exemptions beyond what the Davis Administration had anticipated. The 2002-03 Governor's Budget assumes a sales tax revenue reduction of about \$40 million associated with the provisions of AB 426. However, based upon the recent BOE decision, the tax relief associated with this measure may be closer to \$90 million. The Governor's Budget leaves open the possibility that the Davis Administration will actively seek to over turn the BOE decision through subsequent legislation raising taxes on the agriculture and food processing industry.

GENERAL GOVERNMENT

STATEWIDE ISSUES

Vacant Positions – Phantom Employees Continue To Haunt State Budget

In March 2000, Senator Brulte released an analysis of vacant positions in state government. Using data from the Department of Finance, the analysis focused on the 1998-99 fiscal year, the most recent year of actual data. The analysis estimated that the state had approximately 12,000 vacant positions beyond the 9,800 traditionally associated with the state's budgeted 5-percent "salary savings." In April 2000, *Finance released an extensive report confirming the Republican analysis.* To address this problem, the 2000 Budget Act eliminated approximately 3,600 positions. In addition, the 2001 Governor's Budget proposed to eliminate an additional 3,100 positions. In total, 6,700 of the 12,000 excess positions from the 1998-99 fiscal year have been or will be eliminated. No money was eliminated from any departmental budget due to the abolishment of these 6,700 positions.

According the data from the Controller's payroll database, there were 24,899 vacant positions in state government on January 1, 2002. In addition, Finance has authorized and departments have received funding for an additional 17,874 positions which have never been established in the Controller's payroll database. Therefore, the state currently has approximately 42,773 vacant positions spread throughout various departments and agencies. After adjusting for various blanket positions (i.e. temp help, overtime, data input errors), and the traditional salary savings component, we estimate there are 5,261 funded "excess" vacant positions. Assuming a cost of \$75,000 per position, (Associate level position with benefits and operating expense) these positions account for \$395 million in various "state operating funds." The General Fund accounts for at least 51% of state operations. Given these facts, we estimate at least \$201 million in General Fund savings could be achieved to help balance the budget by eliminating excess vacant and funded positions. We will be reviewing this matter further as budget subcommittees start hearing individual departmental budgets.

Hiring Freeze – Where Are The Savings?

In response to the State's continuing fiscal difficulties, the Governor issued Executive Order D4801 in October 2001, requiring State agencies and departments to implement a hiring freeze through June 2003. The hiring freeze prohibits the use of new hires to fill State positions, excluding specified positions related to public health, safety, security, and other positions producing State revenues. The Administration assumes that the hiring freeze will result in General Fund savings of \$13 million in 2001-02 and \$20 million in 2002-03 as position vacancies increase and salary savings accrue. *However, since the Governor issued his executive order in October, actual vacancies in state government have actually decreased slightly.* The State Payroll Database shows that between October and January, vacancies decreased by 320 positions. Accordingly, it appears that state agencies are not following the executive order – yet. If this trend continues, the assumed \$13 million in savings in the current year will not be realized.

2001-02 Operating Expenses and Equipment Reduction

The Governor issued an October 2001 Executive Order directing state departments to achieve cost savings of at least \$150 million in current year operating expenses and equipment. The cost savings measures included canceling or postponing non-essential travel; reducing, canceling, or postponing any new contract or agreement for the purchase of goods or services; and, when possible, canceling and disencumbering the balance of any existing contract or purchase agreement. The Governor's Budget assumes savings of approximately \$178 million as a result of this directive. This amount will be reverted from individual appropriations pursuant to urgency legislation in the special session. The Administration has not provided any specifics on the impact of these reductions.

1999-00 and 2000-01 Disencumbrances

The Governor also directed state departments to review 1999-00 and 2000-01 encumbrances, for which goods and services had not been received, for potential disencumbrance and reversion. The budget assumes disencumbrances for both years of approximately \$40 million as a result of this review. This amount will be reverted from individual appropriations pursuant to urgency legislation in the special session. The Administration has not provided any specifics on how these disencumbrances will impact state programs.

Increased Pro Rata Assessments

The 2002-03 Pro Rata plan in the budget includes additional allocations to special funds agencies that have not been assessed in the past for services from the central service agencies. The effect of this is to reduce General Fund costs of state administration costs and shift these costs to special funded agencies. The additional allocations will increase recoveries to the General Fund by an estimated \$24 million and simultaneously increase costs to special funded agencies by a like amount.

ANTI-TERRORISM COSTS

The 2002-03 Budget includes \$350 million from the federal government to help offset or fund the costs of anti-terrorism activities at both the state and local level. The funds are allocated as follows:

California Highway Patrol - \$129 million in the 2001-02 and 2002-03 fiscal years for protection and interdiction efforts that would otherwise be funded from the Motor Vehicle Account. Should the federal funds not materialize and the CHP is forced to use MVA revenues

to fund these activities, the MVA could have a negative Fund Balance in 2002-03. However, the Administration is proposing significant fee increases to the MVA to help alleviate the funding shortfall.

Department of Transportation - \$24 million is proposed for bridge security system improvements made in the 2001-02 fiscal year.

Military Department - \$10 million for bridge security efforts.

Budget Control Section - \$187 million is proposed for allocation to state and local agencies for various high priority needs through a new Budget Act Control Section.

DEPARTMENTAL ISSUES

Secretary of State

The Budget proposes \$5.7 million Business Fees Fund to continue funding for the second phase of the Business Automation Program. Phase I of this project, funded in the 2000 Budget Act, will address standardization of the Uniform Commercial Code. Phase II will automate other business processes with overall goals to provide accurate and reliable data, standardize and simplify the processing of business and security interest filings, reduce turnaround time, and provide services through the Internet.

Franchise Tax Board

- **New Positions Not Necessary.** The Budget proposes to increase revenue by adding additional tax auditors and collections agents. The budget assumes that an audit augmentation of 44.6 personnel years and \$4.5 million will return \$52.0 million in 2002-03, and that a collections augmentation of 78.8 personnel years and \$6.2 million will return \$27.5 million in 2002-03. However, the FTB has historically had a trouble filling excess vacancies. As of January 1, 2002, the FTB had 1,182 vacant positions out of an authorized level of 5,524 for a total vacancy rate of 21 percent. It is unclear that the Administration will be able to actually fill the audit and collections positions. Accordingly, their revenue assumptions are probably significantly overstated.
- **Tax Protest Backlog Not Addressed.** When taxpayers are assessed taxes by the Franchise Tax Board (FTB), they have the right to file a formal protest if they believe they are being incorrectly assessed by the state. This protest process typically takes many years to complete because when the protest is filed, the taxpayer encounters a bureaucracy that lacks uniform rules of governance and time frames for getting things done. The result is that in complicated cases, the average time for completion is more than 38 months. Because of the FTB protest process, there is over \$1 billion of tax assessments sitting uncollected in a bureaucratic black hole. These assessments are a result of a tax protest backlog that the FTB simply does not process quickly or efficiently. By not dispensing with these protest cases, taxpayers who should not be liable for the amounts owed can not get resolution and have to continue spending legal fees to get state bureaucrats to take action on their cases. Furthermore, for those cases where the taxes should rightfully be collected, the FTB delays deprive the state General Fund of badly needed revenues. *The Governor's Budget completely ignores this issue.*

Board of Equalization

While the Administration believes that adding positions to the FTB will increase revenues, apparently the same logic does not hold with the state's other main revenue collector – the BOE. The Governor's Budget proposes a reduction to the BOE's budget of \$7.6 and 146 positions. The Administration assumes no loss in state revenues associated with this reduction.

General Services

- **Wasteful Positions Added.** The Department of General Services budget includes 150 new positions for various activities costing the state \$6.7 million. However, it is unclear why any new positions are needed at the Department. As of January 1, 2002, General services had a total of 582 vacant positions which translates into about a 19 percent vacancy rate. Simply filling the vacant positions already on the books could more than adequately address the Department's workload needs.
- **Surplus Property Not Managed Properly.** California law requires that most state agencies review their landholdings (property) each year to identify real estate that exceeds the agencies' property needs. The State considers properties surplus when the agencies that own them no longer use the sites and have no plans to use them in the future. When such properties sit idle, the State does not benefit from funds it would receive by selling or leasing these properties, and it may incur unnecessary maintenance costs. This can cost the state General Fund millions of dollars annually. Moreover, until leased or sold, these properties are not available for other purposes, such as housing, parks, or open space. The Department of General Services can take years to dispose of surplus property. In fact, its current surplus properties have been pending disposal for an average of 6.7 years. This property management system can and must be improved to ensure that the state General Fund is not being denied additional revenues. The Governor's Budget completely ignores this issue.
- **State Office Building Costs Too High.** The cost for the state to lease office space in the San Francisco Bay Area is considerably higher than elsewhere in California. For example, San Francisco office space leases from \$4.50 per square foot to \$8.00 per square foot. By comparison, Sacramento rates range from \$1.50 to \$3.00. When offices are needed in San Francisco to serve the public in that community or are required by law to be located there, these high costs are basically unavoidable. But if it is not necessary to have state employees working in leased space in San Francisco, the state can realize savings by locating those state offices elsewhere, or relocating them to state-owned buildings in San Francisco. The Administration should direct the Department of General Services to relocate state offices, where possible, in high-cost areas that are not needed to serve the local community to less expensive areas when the current leases can be canceled. The Governor's Budget completely ignores this issue.
- **No Plan to Restore Emergency 911 Funding.** Technology has improved to get a better fix on the origin of wireless calls. This new technology permits the wireless network to determine whether a call is more likely to come from a freeway or from a city or unincorporated area. The funding necessary for the infrastructure improvements to implement advanced wireless 911 technology was included in the Governor's 2001-02 Budget. The Budget proposed local assistance funding of \$31.6 million in 2001-02, \$39.9 million in 2002-03 and additional funding in future years to move the state towards full implementation of this new public safety technology. The appropriation for this proposal

was to come out of the State Emergency Telephone Account, which is funded through surcharges on customer wireless telephone accounts. However, the Davis Administration proposed in late June to raid this account by transferring the fund balance (\$63 million) from this special fund into the state General Fund to pay for bureaucrat salaries and other general government programs. The 2002-03 budget does not propose any alternate source of funding for this critical project. As a result of this special fund raid, the state's 911 technology enhancement program will be significantly delayed thus jeopardizing public safety.

Department of Housing and Community Development

The 2002-03 Governor's Budget proposes to reduce funding for state housing programs by the following amounts:

- Self-Help Housing Program by \$2.1 million.
- Emergency Housing Assistance Program by \$2 million.
- Multifamily Housing Program by \$ 29.45 million.
- Downtown Rebound Program by \$3 million.
- Farmworker Housing Grant Program by \$3.59 million.

The budget assumes that some portion of this funding will be replaced by general obligation bonds approved by the Legislature and placed on the November ballot.

Department of Corporations

- **Fees Are Too High.** The Department of Corporations (DOC) is supported by license fees and assessments charged to regulated companies. Pursuant to Chapter 328, Statutes of 1998, DOC suspended certain filing fees, effective July 1, 1998 through June 30, 2000, to reduce the surplus in the State Corporations Fund. These fees were reinstated for 2000-01. However, the DOC fund balance remains very high. In the 2001-02 budget year, revenues are estimated at \$32.1 million, while proposed expenditures are \$23.5 million. This would leave an end-of-year fund balance of \$38 million, or 162 percent of proposed expenditures. The LAO recommends a prudent fund balance of around three months, or 25 percent, of annual expenditures. For DOC, this level of reserves would total \$5.9 million, or \$32.1 million less than the indicated fund balance at the end of 2001-02. Rather than reducing fees, the Davis Administration is ripping off \$20 million from the fund balance as a loan to the General Fund to support bureaucrat salaries and general government.
- **Predatory Lending Initiative.** The budget proposes an augmentation of 17 new positions and \$10 million for the DOC to increase public awareness, increase call center assistance and to do investigations and enforcement of predatory lending practices. This initiative is in conjunction with the Department of Financial Institutions and the Department of Real Estate.

Department of Information Technology

- **Mismanagement and Poor Leadership Continues.** The State spends over \$2 billion annually on information technology (IT). In the past, the state has experienced several major failures in IT systems. The Legislature passed legislation that resulted in the creation of the Department of Information Technology (DOIT) in 1996. At that time, the Legislature envisioned that DOIT would provide the leadership, guidance, and oversight needed to protect the State's investment in IT. However, the DOIT has not delivered what it has been

asked to do by the Legislature. A recent audit by the BSA made numerous disturbing findings. These include:

- The DOIT did not have an operative strategic plan;
- DOIT does not regularly perform post implementation and evaluation reports;
- DOIT suffers from poor record keeping. It lacks a state IT project inventory;
- DOIT suffers from high turn over of key employees and from poor executive leadership;
- Major state IT projects routinely have significant cost overruns;
- DOIT has not established and issued key policies and common project rules;
- DOIT is not working directly with Departments to review their IT plans.

Because the Governor's Budget continues to fully fund DOIT at \$9.6 million, a close review of its functions and role in state government by the Legislature is needed. *Elimination of this Department with its key functions distributed to other state entities would probably result in better IT management **and** lower state costs.*

California Arts Council

The CAC budget has grown dramatically over the last few budget cycles. In 1997-98 total CAC expenditures were \$14 million. The Budget Act of 2001 funded the CAC at \$51 million. This \$37 million expansion represents a 264 percent increase in just 4 years! All of this funding increase is for discretionary expenditures, which are rapidly becoming another source of "pork barrel" budget projects for those legislators who have special influence in the Governor's Office. The 2002-03 Governor's Budget continues to fund the CAC at \$32.8 million. Returning to the 1997-98 level of funding would save the General Fund \$18 million.

Technology, Trade and Commerce Agency

- **Foreign Trade Offices Continue to Waste Money.** The Trade and Commerce Agency (TCA) operates 15 foreign trade offices throughout Latin America, Europe and Asia. In 1997, the TCA had a trade office budget of \$4.4 million. In just four years this amount has grown to \$6.1 million – a 39 percent increase in five years. There has been no data coming from the TCA to justify such a large expansion of the trade office program. Furthermore, the TCA has never set specific goals or established firm criteria upon which the results of these offices could be evaluated. Most of the information coming out of the TCA are broad generalizations about how these trade offices are performing. This program should either be eliminated, or scaled back to pre-1997 staffing levels. The 2002-03 Governor's Budget fully funds these offices.

Infrastructure Bank Goes Into Debt

AB 1495 (Peace)/Chapter 94, Statutes of 1994 created the California Infrastructure and Economic Development Bank (Bank) which was intended to facilitate public investments in infrastructure. In 1999, Senate Republicans proposed to capitalize the Bank with \$425 million in state funds making a total of \$475 million to operate the Bank. The Democrats and Governor agreed with Republicans and the funding was approved in the Budget Act of 1999. However Governor Davis rapidly back-tracked on that commitment. Last year, the Governor's May Revision proposed transferring \$177 million of the Infrastructure Bank fund balance to the General Fund to pay for state programs and bureaucrat salaries. The Budget Act increased the transfer to \$277 million! This action virtually eliminated the bank's ability to make low-interest loans to local communities for various capital projects. As a result of this robbing Peter to pay

Paul policy, the Davis Administration now proposes to incur more debt by selling bonds to raise funds for the bank. The 2002-03 budget assumes the sale of \$120 million in revenue bonds so that the bank may continue to operate.

EMPLOYER RETIREMENT CONTRIBUTIONS

Public Employees Retirement System – In December 2001, the CalPERS Board of Administration voted to reduce State and School employer contribution rates for the 2001-02 and 2002-03 fiscal years in exchange for the State providing a higher level of purchasing power protection for State and school retirees. As a result, the Budget reflects a proposal to defer a significant portion of the State's 2002-03 retirement obligation to CalPERS. Based on the proposal, the State's 2002-03 obligation will be reduced by \$543 million (\$371 million General Fund) with an additional credit of \$415 million coming from over payments in the 2001-02 fiscal year. However, the CalPERS Chief Actuary is estimating that the Retirement Fund will have a five percent unfunded liability within 36 months, and the CalPERS Board will require that the liability be eliminated over the next 30 years. Therefore, the 30 year cost of the proposed deferral, including interest, is estimated at \$3.3 billion.

In return, the Administration is proposing legislation that will guarantee that retirees' monthly PERS benefits will not fall below 80% of the purchasing power of their initial retirement allowance (instead of the current 75%) beginning in January 2005. This benefit enhancement is estimated to cost approximately \$1.6 billion. **When added to the employer contribution deferral, the total cost of this proposal is approximately \$5 billion for future generations.**

State Teachers Retirement System – Similarly, the Budget reflects a proposal to defer General Fund contributions to STRS in exchange for increased contributions to the STRS' Defined Benefit Supplement accounts (separate tax-deferred accounts). This proposal would result in reduced General Fund expenditures of approximately \$96 million in 2001-02, \$412 million in 2003-03, and \$441 million in 2003-04. **While the actual repayment terms or total costs of this proposal are not currently known, based on the CalPERS deal, the State will be taking a substantial portion of money away from the classroom and the children in our public schools for generations to come.**

STATE INFRASTRUCTURE AND BOND DEBT SERVICE

The 2002-03 Capital Outlay Budget

The Governor's 2002-03 Budget proposes \$1.24 billion in capital outlay expenditures, exclusive of transportation, K-12 schools, and State conservancies. Of this amount, \$979 million is for continuing phases of previously approved projects and \$256 million is for new projects. Funding for this program comes from a number of sources including general obligation bonds, lease revenue bonds, various special funds, federal funds and some General Fund. In addition to the \$1.24 billion in capital outlay funds, the Governor has proposed a "economic stimulus package" of \$678 million funded with lease revenue bonds for additional public works projects which consist primarily of the acceleration of the construction of higher

education facilities. Combined together, the total package is \$1.9 billion – *the same level as proposed last year.* Given that the Governor is not proposing any higher level of state capital spending this year than he did last year, it is uncertain how his “stimulus package” will actually stimulate any new jobs. Rather, it looks like he is simply maintaining the current level of state public works as in the past.

Highlights of the 2002-03 capital outlay program contained in the proposed Budget are as follows:

- **Higher Education:** \$1.15 billion which includes \$365 million for the University of California, \$450 million for the California State University, and \$340 million for the California Community Colleges from proposed future general obligation bonds and the General Fund.
- **Department of General Services:** \$174 million for various state office construction projects and the Seismic Retrofit program.
- **California Science Center:** \$97 million for phase 2 of a 4 story addition to the existing Science Center. This is proposed to be paid for with \$19 million in state lease revenue bonds and \$78 million in private donations.
- **Department of Transportation:** \$86 million to replace the San Diego District office building and several other minor projects.
- **California Highway Patrol:** \$12.2 million for three continuing projects in Monterey, South Lake Tahoe and Williams.
- **Department of Motor Vehicles:** \$8.31 million for the Sacramento headquarters building asbestos removal program and three other projects.
- **Department of Parks and Recreation:** \$58 million for various park improvement projects around the state.
- **California Conservation Corps:** \$12.9 million for continuing projects.
- **Department of Forestry and Fire Protection:** \$53 million for various state projects.
- **California Department of Corrections:** \$22.5 million for various projects around the state.
- **Department of Youth Authority:** \$19 million for the continuing phases of 4 previously approved projects.
- **Department of Food and Agriculture:** \$21.2 million, to continue the replacement of agricultural inspection stations.

- **Military Department:** \$9.5 million for one new project and various other minor capital outlay projects.
- **Department of Health Services:** \$48 million in lease revenue bonds for the continuing phase of the previously approved project to construct a Phase III office building at the Richmond Laboratory Complex.
- **Department of Mental Health:** \$21 million for various projects.
- **Judicial Council:** \$32 million in lease revenue bonds for the continuation of two new courthouse projects in Santa Ana and Fresno.
- **Department of Justice:** \$10.5 million for the statewide DNA laboratory and for the Santa Barbara Replacement Laboratory.

State Debt Position Deteriorating Rapidly

A common measure of bonded indebtedness is the ratio of tax-supported debt to General Fund revenues. Most municipal credit rating agencies generally like to see debt ratios of 5 percent or less. California's General Fund debt ratio for 2001-02 is 4.6 percent and would rise to a maximum of 5.4 percent in 2003-04 under the Governor's plan. California's General Fund debt ratio has not been this high since 1994-95.

However, the very high debt ratio does not take into account all of the additional short term borrowing that the Davis Administration has incurred. For example, in October the Administration issued a \$5.7 billion revenue anticipation note (RAN), *the largest in the state's history*. In addition, the Administration took out a \$4.2 billion "bridge loan" to help finance energy purchases. It is also seeking \$14 billion in energy revenue bonds to bail out the General Fund from last year's energy purchases and to pay off the bridge loan. Furthermore, the 2002-03 budget proposed by Governor Davis would borrow an additional \$3.7 billion from internal special fund sources to finance the budget shortfall. Finally, the Administration is proposing \$30 billion in new school bonds over the next three election cycles. When added all together, the Davis Administration is setting the stage for California to enter an era of unprecedented debt. A significant portion of which is being used for day to day operating expenses of the state. In other words, the Governor's Budget is mortgaging the future to pay for today's general government expenses.

General Obligation Bonds

California currently owes \$20.5 billion in principal on outstanding non-self liquidating general obligation (GO) bonds as of the end of calendar year 2001. The State General Fund cost for the payment of interest and redemption on these bonds is \$2.5 billion in 2001-02 and is estimated at \$2.6 billion in 2002-03.

Lease-Revenue Bonds

The State also uses lease-revenue bonds to supplement the GO bond program. Outstanding lease-revenue bonds totaled \$6.4 billion as of December 1, 2001, and are estimated to total

\$6.7 billion as of June 30, 2002, and \$6.5 billion as of June 30, 2003. The State General Fund cost for lease payments (principal and interest) was \$533 million in 2000-01 and is estimated to be \$526 million in 2001-02 and \$555 million in 2002-03.

TRANSPORTATION, RESOURCES, AND ENVIRONMENT

Budget Reneges on Transportation Congestion Relief

The 2002-03 Governor's Budget once again reneges on Gov. Davis' promise to alleviate commuter gridlock. Last year, the Governor and legislative Democrats took \$2.5 billion from the Traffic Congestion Relief Fund (TCRF) to pay for non-transportation related costs. With very little money remaining available in the TCRF, the Budget proposes, in essence to use this fund as a shell to funnel State Highway Account funds into the General Fund.

Specifically, the Budget proposes to loan the General Fund \$672 million from the TCRF. Since this is more than the available balance in the TCRF, the Budget further proposes to loan \$474 million from the State Highway Account (SHA) to the TCRF to make up the difference. It is unclear whether this subterfuge will avoid violating the court's order in *Professional Engineers In California Government Vs Wilson II (PECG II)* court case, but it clearly flies in the face of the Governor's assertion in his state-of-the-state address and elsewhere that he has taken action to reduce congestion.

DMV Budget Raises Fees

The Governor's Budget also proposes several **fee increases** to shore up the Motor Vehicle Account, which will experience several cost pressures. For example, the CHP's retirement plan that had been fully funded with investment earnings has experienced a drop in revenues due to the decline in the stock market. A backfill of \$107 million have been proposed to support the drop in revenues. Also, last year's budget contained an MVA appropriation of \$20 million to support the ARB's zero emissions program. The fee increases are as follows:

- \$25 million from increasing late registration fees, which will increase to \$50 million in 2003-04.
- \$2 million from increasing filing fees on appealing DUI suspensions, which is expected to increase to \$4 million in 2003-04.
- \$40 million from increasing the cost to insurers and others that request driving record information.
- \$4 million in 2003-04 from the imposition of a \$5 fee to retake a driving license test.

These fees amount to an indirect tax of \$67 million in 2002-03 and \$98 million in 2003-04.

Governor's Budget Highlights

TRANSPORTATION

Department of Transportation

The budget proposes \$9 billion from various funds for Caltrans in 2002-03, which reflects an increase of approximately \$1.2 billion over the current year. The increases are mostly from the State Highway Account (\$279 million), Federal Trust Fund (\$643 million), and the TCRF (\$333 million). In addition to the loan transfers from the SHA to the TCRF stated above, the expenditures from the SHA capital outlay support program area are overly optimistic. Over the past ten years, Caltrans has delivered on only 60 percent of SHA capital outlay projects.

The other major proposed increases are:

- \$10 million for the Fleet Greening Initiative. The program supports the replacement and retrofit of Caltrans' fleet from gasoline or conventional diesel fuel burning cars to those using cleaner burning fuels.
- \$5 million for a new competitive grant component of the existing Freeway Service Program.

High Speed Rail Authority

The budget proposes \$8.5 million in various special funds in 2002-03, which reflects an increase of approximately \$4.9 million over the current year. The budget proposes an additional \$7 million from the SHA (see below), however, reimbursements are down \$2 million from the current year.

The major proposed increases are:

- \$7 million SHA to finish the environmental impact report for a "bullet train" that is proposed to run down the Central Valley. This project could cost the state over \$30 billion to build.

RESOURCES

Department of Forestry and Fire Protection

The budget proposes \$498.1 million (\$311.8 million General Fund and \$186.3 million in various special funds) for CDF in 2002-03, which reflects a decrease of approximately \$150 million over the current year, of which approximately \$145 million is from the fire protection program.

The major proposals are:

- The Budget undercuts the Governor's promise to maintain public safety by proposing a reduction of \$55 million from the elimination of the Emergency Fund and budget language

that allows the Department of Finance to examine the “actual costs” of fire-fighting through an administrative process.

- The Governor's Budget will increase costs to local governments by charging them \$20 million for fire-fighting activities on State Responsibility Areas (SRA's). Currently, this cost is covered by the General Fund.

Department of Fish and Game

The budget proposes \$253.1 million (\$56.8 million General Fund and \$196.3 million in various special funds) for DFG in 2002-03, which reflects a decrease of approximately \$19 million (\$12.2 million General Fund) from the current year.

The major proposals are:

- Decrease of \$2.2 million General Fund for the Marine Management Program and replace the revenue with anticipated funds from the passage of Proposition 40 on the March 2002 ballot.
- Decrease of \$8 million General Fund for salmon habitat projects and replace the revenue with anticipated funds from the passage of Proposition 40 on the March 2002 ballot.
- General Fund reduction of \$2.1 million for CEQA reviews, \$1.2 million from CALFED activities, and \$1 million for local coastal planning grants.

CALFED

The budget proposes \$519.3 million (\$58.9 million General Fund and \$460.4 million in various special funds) in 2002-03, which reflects a decrease of approximately \$148.2 million from the current year. According to the Governor's Budget, the Administration assumes that the state will receive \$110.3 million from the federal government for CALFED in the current year. However, the federal government's budget does not contain anywhere near that amount for the CALFED program. Also, the Governor's Budget anticipates \$101.1 million from Proposition 40 funds if it is passed by the voters on the March 2002 ballot.

Parks and Recreation

The budget proposes \$316.4 million (\$112.4 million General Fund and \$204 million in various special funds) for DPR in 2002-03, which reflects a decrease of approximately \$832 million compared to the current year. Most of this reduction reflects an appropriation of one-time Proposition 12 funds (\$680 million) and \$15 million in Natural Resources Infrastructure Funds for the Urban Parks Initiative.

The major proposals are:

- Replace \$10 million General Fund for deferred maintenance with anticipated Proposition 40 funds.

- Partially offset a \$17 million General Fund reduction with \$15 million in MVA funds, which already has several cost pressures.
- Expenditures of \$48.2 million in special funds to local agencies for recreational facilities, historic preservation projects, and habitat protection efforts.

Tidelands Revenue

Currently, the State Lands Commission collects revenue from sale of tidelands oil, then it disburses the revenue among various special funds for particular programs. The statutory requirement that these funds be disbursed among various special funds will expire on January 1, 2003. The Administration intends to let the statutory authority sunset and deposit these revenues into the General Fund to be appropriated for other purposes. This action would result in an annual increase of approximately \$70 million for the General Fund.

ENVIRONMENT

State Water Resources Control Board

The budget proposes \$664 million (\$87 million General Fund and \$580 million in various special funds) for the Board in 2002-03, which reflects a decrease of approximately \$394 million from the current year, primarily due to the elimination of one-time Proposition 13 (water bond) funds.

The major proposals are:

- **FEES.** The Governor's Budget proposes to double the waste discharge permit fees it charges businesses that discharge waste into local water and land. The Waste Discharge Fund, which collects the aforementioned fee revenue, is expected to collect \$15 million in the current year, but is proposed to be increased to \$30 million in the budget year. The Governor's Budget proposes this increase to make up for a reduction of \$15 million General Fund. Businesses will pay twice as much for not a single increase in service.

Air Resources Board

The budget proposes \$133.6 million (\$40 million General Fund and \$93.6 million in various special funds) for the ARB in 2002-03, which reflects a decrease of approximately \$83.5 million from the current year. The lion's share of ARB's proposed reductions are \$29 million General Fund, \$31 million Motor Vehicle Account (MVA) funds, \$7.6 million in Air Pollution Control Funds, and \$5 million in PVEA funds.

The major proposals are:

- \$10 million to local air pollution control boards for enforcement and compliance activities.
- Reduction of \$4.4 million General Fund for stationary source programs and \$10.6 million MVA for mobile source programs.

Energy Initiatives

The budget proposes \$1.56 billion (\$6.5 million General Fund and \$1.55 billion in various special funds) for the following energy related agencies in 2002-03, which reflects a decrease of approximately \$478 million over the current year. Much of the difference is due to one-time legislative spending in the special session (SB 5x and AB 29x) during 2001-2002.

- PUC: \$1.31 billion
- EOB: \$4.2 million
- Energy Commission: \$243.6 million
- Alternate Energy Financing Authority: \$169,000

The Consumer Power and Conservation Finance Authority will receive \$5.5 million, the remainder of the \$10 million loan from the general fund.

These proposed reductions in important energy programs come at a time when the future of California's energy market remains uncertain and unstable. While allowing reductions from one-time spending levels in programs that could be vital in bringing the state's energy market to health, Davis seems to ignore superfluous bureaucratic wastes found in other sectors of the energy regulatory system. For example, the Electricity Oversight Board, which monitors the Independent System Operators, has not met since April and currently has only one board member, yet it will continue to receive over \$4 million in funding.

The budget further proposes that \$150 million be loaned from the Renewable Resource Trust Fund (Energy Commission) to the General Fund. This amount exceeds the total amount of projected revenue expected by \$8 million and is expected to cut the reserve for economic uncertainties in half. The fund is traditionally intended to support the building and repair of renewable energy generation plants and consumer use incentives. California is still feeling the effects of the energy crisis. More generation facilities still need to be built. Various agencies and the legislature are debating over possible renewable portfolio standards.

LOCAL ASSISTANCE PROJECTS

The budget proposes to revert to the General Fund \$40 million from unencumbered member request projects from the 1999-2000 and 2000-01 Budget Acts and \$30 million from member request projects that were approved in the Budget Act of 2001-02. It is not unusual for funds appropriated for member requests to remain unencumbered for some time. Senate Republicans have advocated for the elimination of these pork-barrel expenditures for some time.

K-12 EDUCATION

The Governor proposes the minimum funding level permitted under Prop. 98 for 2002-03. This \$46 billion funding level for K-12 and community colleges consists of \$31.4 billion General Fund and \$14.6 billion local property tax, which reflects a Prop. 98 increase of \$1 billion over the revised 2001-02 level. The Budget proposes reducing the state General Fund contribution to Prop. 98 by \$50.5 million, while increasing local property tax contributions by \$1.1 billion, or 8 percent. Overall, the Budget proposes approximately \$560 million (or 1.2 percent) more in Prop. 98 spending for 2002-03 over the amount in the 2001 Budget Act.

For K-12 education, the Budget proposes \$53.9 billion (\$31.3 billion General Fund, \$12.7 billion local property tax, \$5.5 billion federal funds, \$3.6 billion other state and local funds, and \$813 million lottery funds), which reflects an increase of \$1.1 billion and 2.1 percent over the revised 2001-02 level. This funding represents a proposed K-12 *Proposition 98* per pupil expenditure level of \$7,058, and a *total* K-12 per pupil expenditure level of \$9,236 in 2002-03. The 2001 Budget Act provided \$7,002 per pupil in Prop. 98 funding, which the Governor proposes to cut to \$6,922 in the current year.

In order to fund statutorily required growth and cost of living adjustments and his own priorities in 2002-03, the Governor proposes to cut \$487 million from K-12 education by eliminating existing programs or delaying implementation of, or payment for, other programs.

K-12 Education Highlights

Major proposed increases include:

- \$1.3 billion for growth and cost of living adjustments in apportionments and categorical programs. This reflects a projected 1.07 percent growth in average daily attendance and an estimated 2.15 percent COLA for most categorical programs.
- \$112 million in new Federal Funds to fund special education growth and COLA. Typically, new federal special education funds are used to increase services for special education students. For 2002-03, however, the Governor proposes to use this new federal funding to “free-up” Prop. 98 funds for other priorities.
- \$45 million to expand the Before and After School Program for the budget year. While the Budget claims to increase funding for this program by \$75 million, the claim is misleading in that it reflects the increase over the reduced base that results from the proposed current-year cut of \$30 million.
- \$30 million to augment the Mathematics and Reading Professional Development Program. This program was funded at \$80 million in the current year, but has not yet been implemented.

- \$18.7 million as part of the proposed restructuring of instructional materials and library funding. This restructuring would provide an additional \$27.2 million for textbooks and \$75 million for science laboratory materials, but would cut school library funding by \$83.5 million. Of the \$625 million total funding proposed, \$375 million would be one-time funds.
- \$4 million (in addition to the \$6 million provided in the current year) to fund grants to 5 high schools – at \$2 million each – in order to establish “High Tech High Schools.”

Major proposed reductions include:

- \$250 million in one-time funds for increased energy costs. While nominally earmarked for energy, this funding would actually have been available as a discretionary block grant for schools.
- \$67.8 million for school site block grants. This and the following two cuts are proposed for both the budget year and the current year, despite the fact that many school districts have already budgeted this discretionary funding for the current year. Together, these three cuts result in about \$25 per pupil – or \$625 for a classroom of 25 pupils – less in discretionary funding for schools.
- \$40 million for school district revenue limit equalization.
- \$35 million to offset school districts’ revenue limit PERS reduction.
- \$89.7 million for payment to schools – as required by the Constitution – for 7 specified programs and activities mandated by the state.
- \$43 million cut from Independent Study programs by reducing program funding by 10 percent.

California State Library

The Governor proposes cutting state General Fund support to local public libraries by \$11.2 million in the budget year and \$7.9 million in the current year for a two-year cut of \$19.1 million, or 26 percent below the 2000-01 level.

HIGHER EDUCATION

The Budget proposes base funding increases under the Higher Education Partnership Agreement for UC and CSU of 1.5 percent, 3.5 percent less than was agreed to by the Governor in the Partnership negotiated in the spring of 2000. Overall, the Administration proposes a UC General Fund increase of 1.2 percent (\$40 million) and a CSU General Fund increase of 1.0 percent (\$29 million). Significantly – and in contrast to recent years – the Budget does not include state funding in lieu of student fee increases. Thus, while not

explicitly proposing to increase fees, the Governor has opened the door to for his UC Regents and CSU Trustees to raise student fees.

The Governor proposes cutting state General Fund support for community colleges by 2 percent, or \$59.9 million. Total Prop. 98 support, however, is proposed to increase 3 percent, largely due to a 7.9 percent (\$146.6 million) increase in local property tax revenues. The Governor is proposing significant ongoing programmatic cuts in order to provide growth and cost of living adjustments and to increase funding in other areas, such as part-time faculty salaries.

The Governor also proposes to appropriate \$640 million in lease-revenue bonds to build higher education facilities. These facilities would largely be funded through General Obligation bonds. However, in the current year, the Governor proposes shifting \$91.9 million in General Fund project earmarked for pay-as-you-go financing to lease-revenue financing. Over the next two years, an additional \$218.5 million in programmed General Fund construction projects is proposed to be funded with lease-revenue bonds, adding to the state's long-term debt.

Higher Education Highlights

University of California

The Budget proposes \$4.5 billion (including \$3.4 billion General Fund) for the University of California (UC) in 2002-03, which reflects an increase of \$46 million (\$40.3 million General Fund), or 1.0 percent above 2001-02. No funding was proposed to backfill fee increases, as has been the practice in recent years.

The major increases include:

- \$47.5 million to fund a 1.5-percent increase under the Partnership Agreement, rather than the 5-percent increase previously agreed to by the Governor. This 3.5-percent cut in Partnership funding equates to a loss of \$110.8 million that UC would have received were the Partnership upheld.
- \$63.8 million to fund enrollment growth of 3.9 percent (7,100 students).

The major reductions include:

- \$25 million in energy cost funding cut in both the current year and the budget year.
- \$17 million from UC financial aid programs.
- \$13 million from other programs, including \$4.8 from the K-12 Internet II program.

California State University

The Budget proposes \$3.5 billion (including \$2.7 billion General Fund) for the CSU in 2002-03, which reflects an increase of \$26.6 million, or 0.8 percent above 2001-02. No funding was proposed to backfill fee increases, as has been the practice in recent years.

The major increases include:

- \$37.7 million to fund a 1.5 percent increase under the Partnership Agreement, rather than the 5 percent increase agreed to by the Governor. This 3.5 percent cut in Partnership funding equates to a loss of \$87.5 million that CSU would have received were the Partnership upheld.
- \$78.1 million to fund enrollment growth of 4.0 percent (12,270 students).

The major reductions include:

- \$20 million in energy cost funding cut in both the current year and the budget year.
- \$14.5 million from CSU financial aid programs.
- \$6.5 million from the Education Technology Professional Development Program and \$5 million from the Cal-Teach Teacher Recruitment Program.

California Community Colleges

The Governor proposes cutting the state General Fund contribution to community colleges by 2 percent and funding new programs of questionable merit at the expense of existing programs. Overall, the budget proposes \$6.3 billion (\$2.9 billion General Fund, \$2.0 billion local property tax, \$219.4 million federal funds, \$138.1 million lottery funds, and \$1.0 billion in other state and local funds) in 2002-03 for the California Community Colleges (CCC), which reflects an increase of \$104.2 million and 1.7 percent over 2001-02. Total community college Proposition 98 funding is \$4.6 billion, or 10.21 percent of the Proposition 98 split.

The major proposed increases are:

- \$118.7 million for 3 percent growth (31,864 students).
- \$88.8 million to fund the statutory cost of living adjustment of 2.15 percent.
- \$57 million in ongoing funding (shifted from one-time funding in the current year) to fund increases in part-time faculty salaries. This program is being funded despite its creation of significant out-year budget pressures and a lack of evidence that it will improve instruction or achievement at community colleges.

The major proposed reductions are:

- \$58 million from programs to provide services to CalWorks recipients.
- \$26.8 million from programs to provide matriculation services such as orientation, assessment, and counseling.
- \$44.9 million from other programs, including the Telecommunication and Technology Infrastructure Program (\$19.8 million), the Fund for Student Success (\$10 million), the Economic Development Program (\$9.9 million), and Faculty and Staff Development Programs (\$5.2 million).

California Student Aid Commission

The budget proposes \$694.3 million General Fund for Cal Grants in 2002-03, which reflects an increase of \$155, or 23 percent above 2001-02. This increase is driven largely by SB 1644 (Ortiz and Poochigian), which guarantees a Cal Grant for low- and middle-income students who demonstrate merit in high school or community college.

PUBLIC SAFETY AND JUDICIARY

While year-over-year expenditures in the Public Safety and Judiciary areas of the budget remain fairly flat, **we note that the Administration is proposing over \$160 million in new fee increases to help finance the on-going costs of government.**

Specifically, the Administration is proposing the following legislation to generate \$60.8 million in new General Fund revenues:

- A surcharge of 20 percent on all criminal fines – \$45.8 million, and
- A surcharge of 10 percent on civil filing fees - \$15 million.

In addition, the Administration is proposing various changes to penalties and fees to help resolve the Motor Vehicle Account Fund balance.

Public Safety and Judiciary Highlights

Judicial Branch

The budget proposes \$349.8 million for the Judiciary (Supreme Court, Court of Appeals, Administrative Office of the Courts, and the Habeas Corpus Resource Center) in 2002-03, which reflects an increase of approximately \$2.8 million over the revised current year.

The major proposed adjustments are:

- A 2001-02 fiscal year General Fund savings of \$7.7 million, including \$4.6 million associated with current vacancies, and \$3.1 million associated with Court Appointed Counsel workload reductions.
- A 2002-03 fiscal year General Fund savings of \$3.9 million, including \$2.9 million associated with anticipated vacancies and \$1 million related to Court appointed counsel workload reductions.

Trial Courts

The budget proposes \$2.2 billion (\$1.2 billion General Fund and \$1 billion in various special funds) for State Trial Courts in 2002-03, which reflects a decrease of approximately \$21.3 million over the revised current year.

The major proposed adjustments are:

- A 2001-02 fiscal year General Fund savings of \$28.3 million, including \$7.3 million associated with delayed implementation of new jury reform programs, \$8.5 million related to judicial vacancies at the trial courts, and \$12.5 million as a result of funding costs for technology asset management and security from the Trial Court Trust Fund rather than the General Fund.
- A 2002-03 fiscal year General Fund reduction of \$37.8 million, including \$7.2 million associated with delayed implementation of new jury reform programs, \$7.4 million as a result of funding costs for technology asset management and security from the Trial Court Trust Fund rather than the General Fund, and \$23.2 million in the various trial court operating budgets.
- A one-time transfer of \$28.1 million from the Trial Court Improvement Fund to the General Fund.
- An augmentation of \$51.7 million to meet various trial court operational needs, including salary increases for trial court employees.
- An augmentation of \$14.4 million to fund increased trial court costs such as mail and janitorial services, health benefit increases, and retirement rate increases.
- An augmentation of \$13.4 million to address increased security costs for trial court facilities.
- An augmentation of \$2.3 million for workload increases associated with providing court interpreters to assist non-English speaking defendants in trial court proceedings.

Department of Justice

The budget proposes \$620 million (\$324 million General Fund and \$296 million in various special funds) for the Department of Justice in 2002-03, which reflects a decrease of approximately \$29 million over the revised current year.

The major proposed adjustments are:

- A General Fund reduction of \$5.4 million for inmate related litigation and criminal law workload, including \$3.2 million for Plata v. Davis.
- A General Fund reduction of \$1.1 million for support of anti-trust, natural resources, consumer, and environmental law activities.
- A General Fund reduction of \$5.4 million in the Division of Law Enforcement from overtime and other operating expenses.
- A General Fund reduction of \$2.9 million from information technology improvements.

Department of Corrections

The budget proposes \$4.8 billion (\$4.7 billion General Fund and \$100 million in various special funds and reimbursement authority) for the Department of Corrections (CDC) in 2002-03, which reflects a decrease of approximately \$28 million (\$2 million General Fund and \$26 million in reimbursement authority) over the revised current year.

CDC's inmate population is projected to decrease from 156,409 on June 30, 2002, to 155,721 by June 30, 2003, a decrease of 688 inmates or 0.4 percent. The parole population is projected to decrease from 120,523 on June 30, 2002, to 116,811 by June 30, 2003, a decrease of 3,712 parolees, or 3.1 percent. Taken together, the lower inmate and parole population projections account for approximately \$14 million in General Fund savings.

The major proposed adjustments are:

- A General Fund augmentation of \$10.2 million (\$5.2 million in current year deficiency) to begin the buyout of previously negotiated Institutional Vacancy Plans.
- Due to lower inmate population projections and the effects of Proposition 36, a General Fund reduction of \$5.1 million related to the elimination of five expiring private Community Correctional Facility contracts, and a General Fund reduction of \$3.4 million and the cancellation of 425 Community Correctional Re-entry Center beds.
- A General Fund augmentation of \$21.3 million for increased workers' compensation expenditures.

Department of the Youth Authority

The budget proposes \$416 million (\$336 million General Fund and \$80 million in various special funds and reimbursement authority) for the Department of the Youth Authority (YA) in

2002-03, which reflects a General Fund decrease of approximately \$21 million over the revised current year.

YA's youthful offender (ward) population is projected to decrease from 6,360 on June 30, 2002, to 6,100 by June 30, 2003, a decrease of 260 wards. The parole population is projected to decrease from 4,230 on June 30, 2002, to 4,155 by June 30, 2003, a decrease of 75 cases. Taken together, the lower inmate and parole population estimates account for the majority of General Fund savings.

The major proposed adjustments include:

- A General Fund reduction of \$3.1 million for operating expenses and equipment.
- A General Fund reduction of \$726,000 related to the elimination of a 50-bed sex offender treatment program.
- A General Fund reduction of \$766,000 related to the implementation of a 35-bed mental health program, rather than a 75-bed program.
- A General Fund reduction of \$424,000 related to local detention costs for YA parolees.

Office of Criminal Justice Planning

The budget proposes \$266 million (\$72 million General Fund and \$194 million in various special funds) for the Office of Criminal Justice Planning (OCJP) in 2002-03, which reflects a decrease of approximately \$52 million over the revised current year.

The major proposed adjustments are:

- A General Fund reduction of \$30 million for one-time Local Crime Lab funding in 2001-02.
- A General Fund reduction of \$15 million for the War on Methamphetamines.
- A General Fund reduction of \$3.2 million for various member-requests.

California Highway Patrol

The budget proposes \$1.2 billion in various special funds for the California Highway Patrol (CHP) in 2002-03, which reflects an increase of approximately \$112 million over the revised current year. In addition, the Administration is proposing significant fee increases to the Motor Vehicle Account to fund additional program expansions.

The major proposed adjustments are:

- A \$129.1 million Federal Funds augmentation (\$39.5 in 2001-02 and \$89.6 in 2002-03) for terrorism-related safety and security.

- An MVA augmentation of \$11.9 million for additional workers' compensation costs, and \$87.5 million to fund increased retirement costs.

HEALTH

For 2002-03, General Fund expenditures for health and human services are projected to be \$22.4 billion, which represents 28.4 percent of the state budget. Total expenditures in all four of the largest departments that provide health-related services will **increase** in 2002-03. The proposed budget for the Department of Health Services (including Medi-Cal and Public Health) will increase from \$29.8 billion to \$29.9 billion. The Managed Risk Medical Insurance Board (MRMIB), which administers the Healthy Families Program, will increase from \$673.2 million to \$777.4 million. The budget for the Department of Developmental Services will increase from \$2.7 billion to \$2.9 billion, and the Department of Mental Health will increase from \$2.1 billion to \$2.2 billion.

Health Highlights

Master Tobacco Settlement

The Governor is proposing the "securitization" of a portion of the state share of tobacco settlement funds with the issuance of a \$2.4 billion bond that would require repayment of \$4.24 billion over the next 23 years. Debt-service payments of \$62 million in 2002-03 and \$190 million annually for the next 22 years would be required if the bonds could be sold at the Administration's assumed interest rate of approximately 5 percent. This interest rate could rise significantly if the bonds have to be discounted due to perceived risk. California expects to receive a total of \$25 billion over a 25-year period, half of which represents the state share. In 2002-03, state tobacco settlement revenues are estimated to be \$474 million.

Medi-Cal

The budget proposes \$27.2 billion (\$10.2 billion General Fund) for 2002-03, which is \$200 million (\$400 million General Fund) above the revised estimate of expenditures for the current year. Local Assistance represents \$26.9 billion (\$10.1 billion General Fund) of this total, and is \$445.5 million, or 4.6 percent, above the 2001 Budget Act. The Medi-Cal caseload is projected to increase by 415,000 persons to a total of 6.5 million eligibles. Program expenditures are expected to increase, despite a significant cut in provider reimbursement rates; optimistic projections of substantial additional revenue in the form of drug manufacturer rebates; the assumption of huge savings due to fraud prevention activities; and a near tripling of the DSH "rake-off."

Republican legislators have worked hard over the past several years to improve access to health care for those covered under government health insurance programs by supporting higher Medi-Cal reimbursement rates in an effort to gain and retain medical services providers. The Governor is now proposing to rescind many of the rate increases approved in the 2000-01 budget. Rates will be cut in the following areas: physician services; comprehensive perinatal services; dental services; psychologists; audio and other therapies; respiratory care;

chiropractic services; wheelchair/litter van; shift nursing; and home health. Due to these cuts, the budget reflects savings of \$155.1 million (\$77.6 million General Fund). Payments to providers will be further reduced because Medi-Cal recipients will now be required to make co-payments for most outpatient services, and providers will be allowed to bill recipients directly for such payments. As a result, the budget reflects savings of \$61.2 million (\$30.6 million General Fund).

Although few details have been provided by the Administration, the November Medi-Cal Estimate indicates that state supplemental drug rebates from drug manufacturers will increase from \$233.5 million (\$116.7 million General Fund) in the current year to \$265.4 million (\$132.7 million General Fund) in 2002-03. In addition, under the federal drug rebate program, the Department of Health Services expects to increase the price discounts it receives from \$676.1 million (\$327.2 million General Fund) to \$769 million (\$372.6 million General Fund). Current rebate contracts are for brand name drugs only; however, the budget assumes that drug manufacturers will also be required to pay rebates for all generic drugs. Newly required rebates and/or discounts will be sought from manufacturers of nutritional products and medical supplies, and a mandatory 10 percent supplemental rebate on AIDS and cancer drugs will be imposed.

For the past few years, Republicans have urged the Administration to prosecute Medi-Cal fraud more effectively and recoup as much of the \$1 billion in estimated provider fraud as possible. Although the Legislature has authorized over 240 state staff for this purpose, the response to date has been less than enthusiastic. However, in his State of the State Address, the Governor promised that "By this time next year, it (i.e., Medi-Cal fraud crackdown) will have saved half a billion." No specific proposals for enhanced fraud prevention activities have been provided, and the November Medi-Cal Estimate only indicates a total of \$242.8 million (\$121.4 million General Fund) in Medi-Cal fraud savings for the budget year, not all of which is applied as a reduction to the base budget.

Under the Disproportionate Share Hospital (DSH) Program, public hospitals provide funds that are subsequently matched with federal funds and distributed among various public and private hospitals that serve a disproportionate share of Medi-Cal clients. The State Department of Health Services "rakes off" an administrative fee to process this transaction. The budget proposes increasing this annual fee from \$29.8 million to \$85 million.

Public Health – Childhood Lead Poisoning Prevention Program – Fee Increase

The Governor is proposing that fees paid by gasoline and paint manufacturers be increased in order to augment the budget by \$7.2 million so that 8 permanent staff can be hired by the Department of Health Services to restructure the Childhood Lead Poisoning Prevention Program. Funds will be used to identify more lead-exposed children and to enhance enforcement activities. A state court has found that these assessments are in fact fees, and not a tax.

Healthy Families Program

Total expenditures for the Healthy Families Program are projected to increase from \$556.2 million in the current year to \$657 million in the budget year. Under the present program authorization, the federal government shares the costs of the program with the state on a 2:1 ratio. The budget proposes shifting the majority of state costs from the General Fund to the Tobacco Settlement Fund, which is not a permanent revenue stream and a significant portion of which will be mortgaged to pay future debt service on a bond. The Governor is proposing to delay implementation until July 2003 of the expansion to cover parents of eligible children. This will result in savings of \$54.3 million in the current year and \$160.5 million in the budget year (all Tobacco Settlement funds). The budget also proposes an augmentation of \$64 million (Tobacco Settlement Funds) for an increased caseload of children and a fund shift of \$126 million from the General Fund to the Tobacco Settlement Fund.

The Governor continues to fund the Healthy Families Program as though it were an entitlement and, therefore, projects expenditures for the maximum caseload possible. Historically, this budget has been over-funded each year because enrollments have not matched projections.

HUMAN SERVICES

Human Services Highlights

Department of Child Support Services

Legislation in 1999 authorized the creation of a state agency, the Department of Child Support Services, to oversee and improve child collection efforts and required the implementation of a single statewide child support system, including a statewide automated collection system.

No Marked Improved in Child Support Collections Under New Agency. Prior to creation of the new state agency, child support collections increased by approximately \$200 million annually. Since the creation of the agency, collections have not grown markedly higher but have continued the \$200 million growth trend. At the same time, the current year's expenditures are estimated to grow to almost \$1.2 billion.

Questionable Waiver of Federal Penalties Could Result in a \$181 million Deficit. Federal guidelines require that California implement the statewide automation system. To date, no system is in place and the most optimistic projections are that California will begin its first pilot in the year 2005. Meanwhile, California will be faced with federal penalties annually until the State comes into compliance. In fiscal year 2001-02 alone, the State General Fund will pay \$157.5 million in federal penalties. Next year, this amount is anticipated to increase to approximately \$181 million. The Governor assumes that he will be successful in lobbying the federal government for waiver of these penalties. At this time, there is no indication from the federal government that they will consider the request. If unsuccessful, the Governor will face a \$181 million deficit in this program in 2002-03. Also, federal penalties will be assessed each year until the automation is complete, which is not anticipated for at least another five years.

Department of Social Services

Despite a rapid decline in welfare caseload since implementation of welfare reform in 1998, General Fund spending for the Department of Social Services has grown by \$1.7 billion, an increase of 27 percent in four years. This year, Governor Davis relies heavily on ambiguous increases in funding from the federal government, pilfers money from local government and employers, and makes questionable assumptions to balance his welfare budget, as discussed below.

- **Davis Takes Back \$169 Million from Local Governments.** Under welfare reform, it was agreed that the State would reward the counties for reducing welfare costs as families leave public aid. This year, in order to comply with federal cash management accounting requirements, the State is required to recover unexpended fiscal incentive funds and reallocate the money back in such a manner that it would be considered a state expenditure. In doing so, the Governor proposes to take \$600 million in fiscal incentive monies already allocated to the counties, but will only give back \$431 million. He proposes to use the remaining \$169 million to fund other welfare shortfalls. Counties use these fiscal incentive funds for a variety of purposes including education improvements and public safety enhancements. In essence, the Governor's money shell game resulted in a \$169 million loss to local governments.
- **Budget Weakens County Welfare Fraud Detection/Prevention Efforts.** Currently, counties receive incentive funds from both the State and the federal government to enhance their welfare fraud detection and prevention efforts. The Governor proposes to cut \$5.1 million General Fund from this program. At this time, it is unclear how much this reduction will undercut fraud efforts. However, any increases in welfare costs resulting from undetected fraud would be borne by local, state and federal governments.
- **More Siphoning of Employment Training Funds.** Last year, Governor Davis siphoned \$61.7 million in employment training taxes from employers to pay for job services for welfare recipients. These taxes were originally intended to help employers defray unemployment costs by retraining their workers and returning them to the workforce. This year, the Budget proposes to pilfer another \$30 million to provide services to welfare recipients who are not employed by these taxpayers.
- **\$25.4 Million Reduction in Welfare-to-Work Programs.** These programs provide job training and assistance to individuals to help them obtain and retain self-supporting employment. The Governor proposes to defer the required \$25.4 million General Fund state support for this program until fiscal year 2003-04. At this time, it is unclear how much this reduction will effect employment placement and retention, especially in an economic downturn.
- **Questionable Assumptions Could Result in a \$35 Million Program Deficit.** As part of federal welfare reform, food stamps funding was eliminated for legal immigrants who entered the country after August 1996 and who are not naturalized citizens. In response, California implemented its own food stamps program, the California Food Assistance

Program (CFAP), and funded it entirely with state General Fund dollars. The budget assumes the federal government will fully restore funding for food stamps this year. Although there are pending discussions at the federal level, it is unclear at this time if, when, and how much federal funds will be provided. Absent receipt of federal funds for this purpose, the Governor will face an estimated \$35 million deficit in the program.

Other Social Services Increases/Decreases

Over the current year, spending for the Department of Social Services (DSS) grew by a net total of \$812 million (\$406 million General Fund, \$406 million various special funds and federal funds) from approximately \$15,239 million to \$16,051 million, and increase of 5 percent over the current year. The increases are primarily in the areas of CalWORKs; cash grants for the elderly and disabled under the Supplemental Security Income/State Supplementary Payment Program; and funding for in-home care and assistance under the In-home Support Services program, as discussed below.

CalWORKs. General Fund spending in the CalWORKs program grew by a net total of \$135 million from \$2,019 million to \$2,154 million. The major proposed expenditures for this program are as follows:

- An increase of \$112 million General Fund for welfare cash assistance payments. DSS estimates a 3.9 percent caseload growth above the 2001 Budget Act due to the economic downturn.
- An increase of \$4.6 million General Fund for the Kin-GAP Program, which provides payments to individuals who provide foster care for the children of their kin.
- An increase of \$18.4 million General Fund for child care and other services to CalWORKs recipients.

Supplemental Security Income/State Supplementary Payment (SSI/SSP) Program. This program provides cash grants to low-income elderly and disabled persons.

- A reduction of \$132.2 million General Fund to suspend the State cost-of-living adjustment (COLA) for 2003. SSI/SSP recipients will receive only the federal COLA.
- An increase of \$161.6 million General Fund to fund the full-year impact of the 2002 COLA approved in the 2001 budget.
- An increase of \$63.8 million General Fund for caseload growth.

In-Home Supportive Services (IHSS) Program. This program provides domestic and personal care services (i.e., meal preparation, bathing, etc.) to eligible elderly and disabled persons to help them remain in their homes.

- An increase of \$31 million General Fund to pay for the minimum wage increase to \$6.75.

- An increase of \$80.4 million for caseload growth and increased worker's compensation costs.

Department of Alcohol and Drug Programs

The major proposed adjustments are:

- A reduction of \$12.3 million General Fund to various alcohol and drug treatment and services programs.
- A reduction of \$2.5 million General Fund to the Perinatal Program which provides alcohol and drug treatment services to mothers and their children.

Employment Development Department

The major proposed adjustments are:

- A reduction of \$1 million from \$5 million to \$4 million General Fund for Faith-Based Organizations to provide employment services.
- A reduction of \$3.6 million Contingent Funds resulting from a decrease in employment services to CalWORKs recipients.
- An increase of \$2 billion from the Unemployment Fund for anticipated increases in unemployment benefit payments and staff needed to process claims.
- An increase of \$10.3 million from the Unemployment Administration Fund for estimated appeals workload increases.
- An increase of \$182.9 million in the Unemployment Disability Fund for anticipated increases in disability benefit payments and staff needed to process claims.

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